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DIRECTORATE OF
INTELLIGENCE

Intelligence Memorandum

US Direct Investment in the Less Developed Countries

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ER IM 71-231
December 1971

Copy No. 91

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
December 1971

INTELLIGENCE MEMORANDUM

US DIRECT INVESTMENT IN THE LESS DEVELOPED COUNTRIES

Introduction

1. Both the United States and the less developed countries (LDCs) benefit substantially from their investment relations.(1) Investment income from the LDCs is an important element in the US balance of payments, while US private capital plays a crucial economic development role and contributes to raising living standards in the host countries. Nevertheless, US investors increasingly are a key target of nationalists who to some degree influence the governments of virtually all of the LDCs. US investors in those areas affected by intense nationalist pressures, such as parts of Latin America,(2) have been subject to a variety of punitive actions, including expropriation without compensation.

2. Although radical economic nationalism has not yet become pandemic, pressures for greater domestic control over national resources have risen throughout the world. In many cases, restrictive policies could lead to serious financial and political losses to the United States and slower economic development for the LDCs if new rules acceptable and profitable to both sides cannot be worked out. This memorandum provides a statistical

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1. This memorandum discusses only direct investment, defined as the equity in, and direct parent company loans (plus some nonaffiliated loans but excluding bank and government agency loans) to, a foreign enterprise in which a US resident, organization, or affiliated group owns at least 10% of the voting stock or its equivalent in a nonincorporated enterprise. It does not consider other important forms of private investment such as long-term commercial and bank loans, suppliers' credits, and portfolio investments.
2. Throughout this memorandum, the term **Latin America** is used interchangeably with less **developed countries of the Western Hemisphere.**

Note: This memorandum was prepared by the Office of Economic Research and coordinated within the Directorate of Intelligence.

view of US direct investment abroad, including its geographic and industrial distribution and relative rates of return, and briefly describes the investment policies of both the LDCs and the United States. It also assesses the economic impact on the LDCs and the gains and losses accruing to the United States from these investments.

Summary

3. US direct investment in the LDCs has grown rapidly in the last decade despite rising nationalist pressures that have adversely affected US investment earnings in some areas. This growth has been stimulated by the widening search for raw materials, continuing attractive profit opportunities, and the desire by US-based multinational firms to gain access to new, often highly protected markets. It has also been influenced by the continued receptiveness to foreign capital, management skills, and technology on the part of many LDCs and by US Government encouragement through its investment insurance program of private investor participation in the task of economic development in the LDCs.

4. The book value of US direct investment in the LDCs totaled some $21.4 billion at the end of 1970, almost double the 1960 level. Reflecting an even greater expansion in the developed countries during the period, however, the LDCs' share of total US direct investment abroad slipped from 35% to 27%. Extractive industries account for about half the LDC total -- 39% for petroleum alone -- but manufacturing, which registered the most rapid growth in the decade, now makes up about one-fourth of the total. Despite its relatively poor performance in attracting foreign investors during the 1960s, the Western Hemisphere still accounts for 69% of US investment in the LDCs -- and an 83% share if petroleum investments are excluded.

5. Contrary to charges by many LDC nationalists, the rate of return on US investments abroad, outside the petroleum field, has averaged only slightly higher in less developed areas than in the more politically stable developed countries. While mining and smelting operations generally have been more profitable in the LDCs, manufacturing returns are about the same in both areas, and returns on trade, banking, and other services are lower in the LDCs. To a large extent, the much higher yields on US petroleum investments in the LDCs reflect company pricing policies that result in higher profits on crude production than in refining and distribution.

6. Over the last decade or so, the climate for US direct investment in the LDCs has become less hospitable, and in some areas -- particularly in Latin America -- this trend has intensified in the last couple of years.

In numerous instances, the properties of US firms have been expropriated, sometimes without compensation. In August 1971, for example, 45 expropriation cases and 26 negotiated purchases of US properties were pending in the LDCs. The widespread increase in restrictions and controls on foreign firms is perhaps even more indicative of the changing climate for foreign investment in the LDCs. In general, these controls seek to maximize benefits from foreign capital, management skills, and technology while limiting foreign profits, control, and sectors of operation.

7. Although it is generally conceded that US direct investment has contributed substantially to economic growth and development in the LDCs, it is virtually impossible to quantify this contribution. Statistics available on US investment in Latin America in 1966 do indicate, however, that US wholly- or majority-owned firms accounted for an estimated 15% of the region's aggregate gross domestic product, 60%-80% of its mineral export earnings, and 40% of its exports of manufactured goods. Despite frequent Latin American claims to the contrary, US firms also made an estimated minimum net contribution to the region's foreign exchange receipts of $1.7 billion in 1966 -- not including that share of import savings that would not have occurred in the absence of domestic sales by these companies.

8. US income from direct investment in the LDCs provided about $3.1 billion in foreign exchange in 1970 -- slightly more than the $2.9 billion from similar investments in developed countries. Moreover, investment income from the LDCs in the 1960s was much greater than new capital outflows to them, and the gap has been growing. The surplus for LDCs was $2.2 billion in 1970, compared with a $0.5 billion deficit for developed countries. The petroleum sector provided about 80% of this surplus. Because of the complexity of the trade effects of US foreign direct investment, an accurate netting out of total US balance-of-payments gains is not possible, but the adverse effects on the US trade balance probably has not significantly offset investment income gains from the LDCs.

9. Despite a less than hospitable climate in many LDCs, growing US dependence on foreign sources of raw material supplies and attractive profit opportunities still available in some areas will generate continued growth in US direct investment in the area as a whole over the next several years. Those more advanced LDCs promising stability in investor rules and some isolated countries not yet greatly affected by economic nationalism will attract the largest share of this capital. Manufacturing may continue to increase its share of US investment in the LDCs, but equally profitable opportunities in the developed countries will make such investment highly sensitive to hostile policies. Although mining firms will continue to shift investments to developed areas of lower risk, there is a limit to their ability to do so, given the distribution of known world resources. Because of the

expected continuing decline in petroleum's share of total US direct investment in the LDCs and further squeezes on company earnings by members of the Organization of Petroleum Exporting Countries (OPEC),[3] overall investment rates of return should continue to decline in the 1970s. This adverse trend probably will be reinforced by unfavorable host-country policies in other sectors as well as by stiffer competition from Western Europe and Japan for manufacturing investment opportunities.

Discussion

The Statistical .ting

10. At the end of 1970 the book value[4] of US direct investment abroad totaled some $78 billion, almost two and one-half times its 1960 level. During the decade, US investment in the LDCs rose from $11.1 billion[5] to $21.4 billion, but the LDCs' share of US investment declined from 35% to little more than 27%. Although most of this slippage is attributable to the relatively low rate of investment in the less developed countries in the Western Hemisphere, this area still accounts for 69% of total US investment in the LDCs (see Table 1 and Figure 1).

11. Direct investment in extractive industries continues to represent the lion's share of US holdings in the LDCs. Despite declines in their shares in the past decade, in 1970 the petroleum sector still accounted for about 39% of total book value and mining and smelting operations for an additional 12%. These investments – mainly in Latin American and African minerals and Venezuelan and Middle East oil – reflect the worldwide search for raw materials required by the more developed countries. Manufacturing activities, however, showed the greatest power to attract new US capital during the 1960s, and now account for more than one-fourth of US direct investment in these areas. Manufacturing investments serve mainly to develop import-substitution industries in Latin America and in the larger Asian countries, but in Hong Kong, Taiwan, and South Korea, and in Mexican border industries they are intended primarily to expand output for the US and other export markets. Important shifts also have occurred

3. The member countries of OPEC are Abu-Dhabi, Algeria, Indonesia, Iran, Iraq, Kuwait, Libya, Nigeria, Qatar, Saudi Arabia, and Venezuela.
4. Book values are the cumulative values of investments (including reinvestments) made at various times, less depreciation and losses; they usually understate, often substantially, the current value of these investments.
5. Excluding the $956 million investment in Cuba still carried in US statistics at that time.

Table 1

Distribution of US Foreign Direct Investment in the Less Developed Countries a/

Million US $

	1960	1966	1969	1970
Total	*31,865*	*54,711*	*71,016*	*78,090*
Developed countries	19,319	36,633	47,886	53,111
Less developed countries, by area	11,128	16,062	20,045	21,417
Latin America	8,365	11,448	13,841	14,683
Africa	639	1,474	2,227	2,612
Middle East	1,163	1,669	1,805	1,645
Asia and Pacific	961	1,471	2,172	2,477
International-unallocated	1,418	2,016	3,085	3,563
Less developed countries, by sector	11,128	16,062	20,045	21,417
Mining and smelting	1,544	1,849	2,339	2,481
Petroleum	5,034	6,911	7,845	8,377
Manufacturing	1,727	3,841	5,159	5,482
Other	2,823	3,462	4,700	5,078

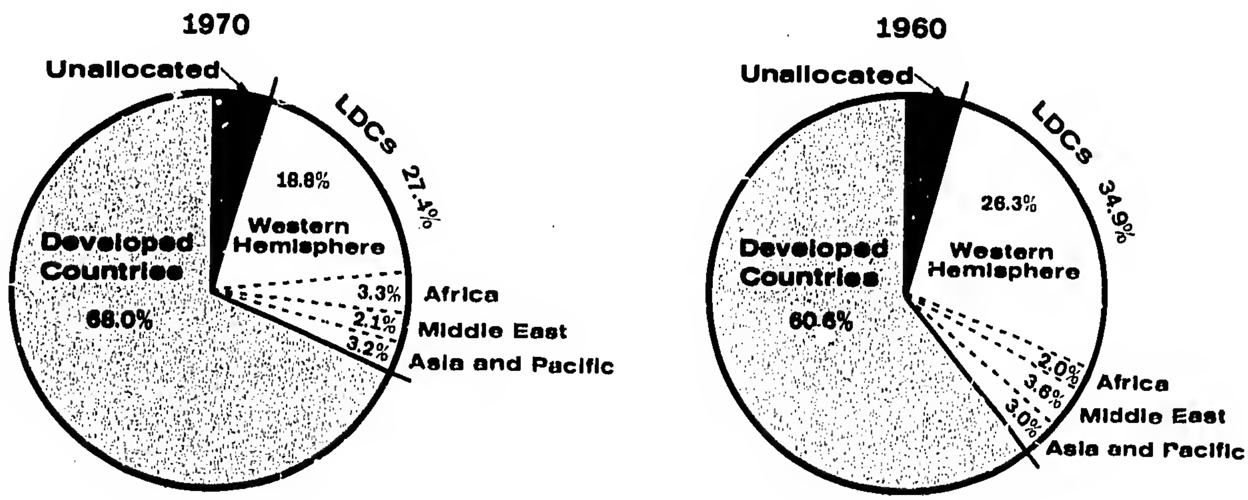
a. The date in this table are book values. Because of rounding, components may not add to the totals shown.

among other sectors which supply mainly services for the local market. Trade and financial institutions gained new capital while investment in public utilities and transportation declined sharply as a result of continued nationalizations during the 1960s.

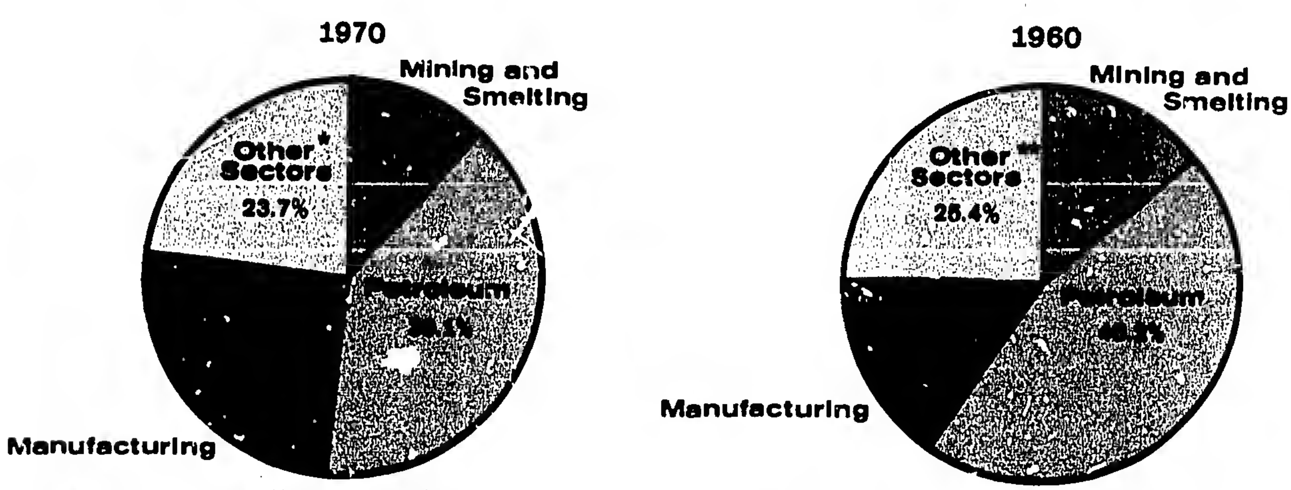
12. The Western Hemisphere holds a predominant share of US direct investment in the LDCs in all sectors except petroleum, and even in that industry it more than matches the Middle East and Africa combined. Excluding petroleum, 80% to 85% of US investment in the LDCs has been channeled into Latin America (see Figure 2). In the manufacturing sector, three countries -- Brazil, Mexico, and Argentina -- alone account for three-fifths of US investment outside developed areas of the world. Although

Geographic Distribution of US Foreign Direct Investment

Figure 1



Sectoral Distribution of US Direct Investment in Less Developed Countries



*Estimated Breakdown: Transportation and Utilities 4%
Trade 9%
Other 11%

**Estimated Breakdown: Transportation and Utilities 10%
Trade 7%
Other 8%

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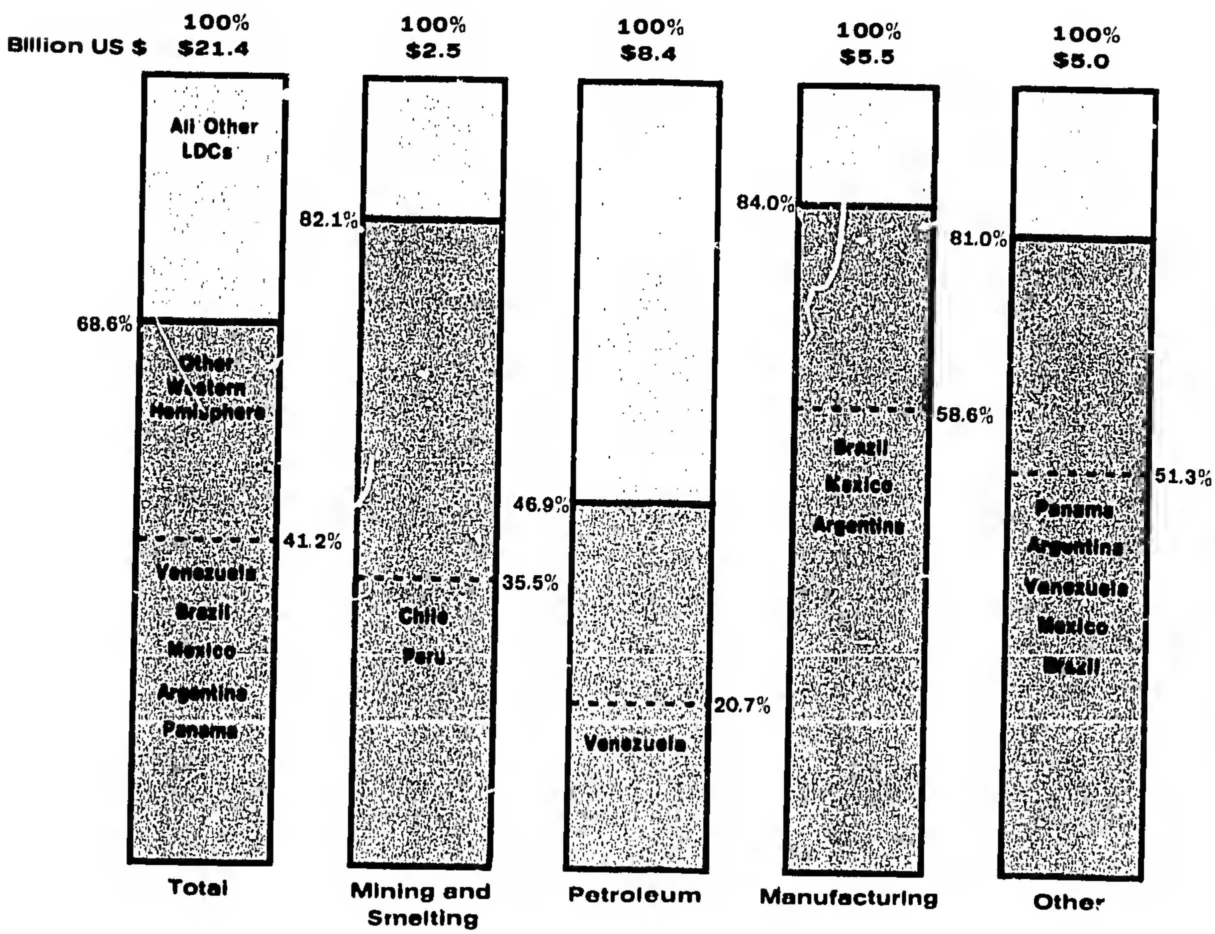
Western Hemisphere Share of US Direct Investment in the Less Developed Countries, by Sector, 1970

Figure 2



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the share of the smaller Asian countries in US direct investment in the LDCs is still minuscule, the rapid growth of US manufacturing investment and of competition by US subsidiaries in areas like Taiwan and Hong Kong has generated the greatest concern in the United States. Latin America also holds 82% of the US capital that is in LDC mining and smelting operations -- and, indeed, it holds two-thirds of worldwide US investment outside of Canada, despite expropriations in such countries as Chile and Bolivia and ownership restrictions elsewhere in the region. Because of large-scale involvement in Latin American trade, finance, and tourism, this area accounts for more than four-fifths of US investment in the LDCs in all other sectors as well.

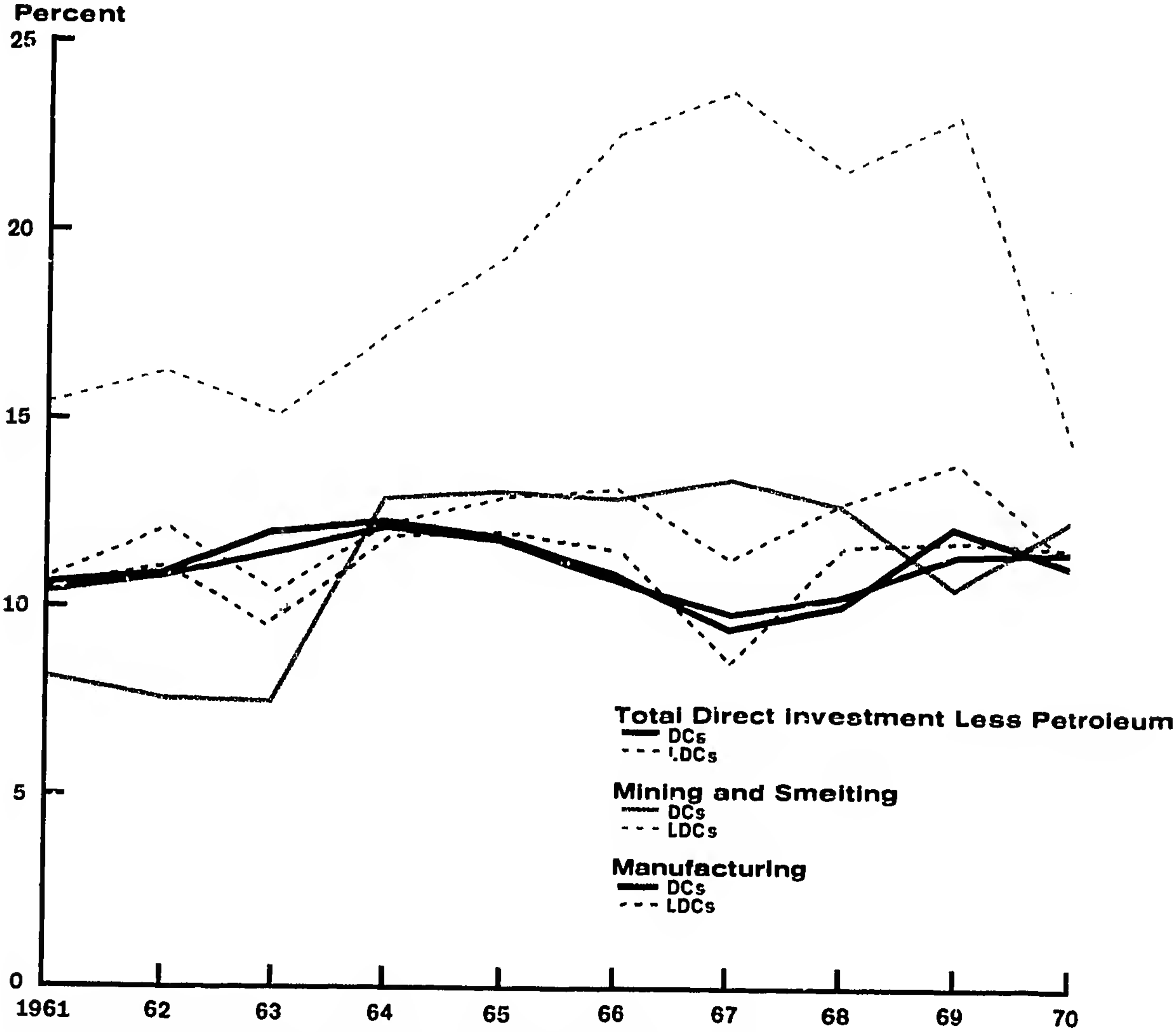
13. Contrary to nationalist allegations of excessive profit-taking by US firms operating in their countries, the rate of return on US foreign direct investment in all fields except petroleum generally averages only slightly higher in the LDCs than in developed countries. During the 1960s, the rate of return on total US direct investment (excluding petroleum) was never more than about 2 percentage points higher in the LDCs than that derived from US operations in the developed countries, and in 1970 the rate for LDCs averaged slightly lower (see Figure 3). Comparative rates of return vary widely among sectors. Mining and smelting operations in the LDCs generally have been far more profitable, with rates of return averaging 19% during the 1960s, compared with 11% in the developed countries. In 1970, however, plunging profits in Chile and Peru brought the LDC average return on US mining investment down to 14% -- only 2 percentage points above the average rate in lower-risk countries in the developed area. Manufacturing investments in the LDCs and developed countries, on the other hand, yielded the same average return of 11% during 1961-70. Returns on investment in other sectors (not shown in Figure 3) have been consistently lower in the LDCs throughout the period, averaging almost 2 percentage points below the 11% earned in developed countries.

Policies of the Less Developed Countries Toward US Direct Investment

14. With some notable exceptions, the LDCs until recently welcomed US direct investment with relatively few restrictions. Although many LDCs nationalized foreign-owned railroads and some other public utilities during the first half of the century and have continued to restrict foreign entry into these fields, they generally encouraged foreign investment in extractive industries, manufacturing, and services such as trade, banking, and insurance. This was especially true in postwar Latin American manufacturing where many governments, seeking to accelerate economic development and increase economic self-sufficiency, provided substantial tariff and fiscal incentives to US investors on more or less the same footing as domestic

Rates of Return* on US Foreign Direct Investment in Developed Countries and Less Developed Countries

Figure 3



*Earnings as a percent of book value of direct investment at beginning of year

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firms. Partly reflecting their more recent colonial status and continued ties with former metropoles, larger Asian countries and most of the newly independent countries in Africa in the past tended to accept US direct investment somewhat less enthusiastically than those in the Western Hemisphere.

15. Over the last decade or so, however, the climate for US direct investment in the LDCs has become less hospitable, and in some areas this trend has intensified markedly in the last couple of years. At least ostensibly motivated by fears that foreign investors are plundering their natural resources, contributing too little to their well-being, and exercising undue local political influence, the LDCs have sought to curb the role of foreign business. While the more extreme actions have occurred mainly in Latin America and Africa, few LDCs (except for some of the smaller East Asian countries such as Taiwan, Hong Kong, South Korea, and Malaysia) remain havens for relatively unrestricted US direct investment. Much of this rising nationalism is based on popular stereotypes of predatory foreign capitalists from an earlier era and, perhaps more important, on a growing disillusionment with economic development as a means of achieving rapid social progress. Nevertheless, it reflects deep-seated socio-political trends that the United States can do little to deter, either through generous aid or threat of economic reprisal.[6]

16. Recent takeovers of US business properties are the most conspicuous illustration of rising economic nationalism in the LDCs. As of August 1971, some 45 expropriation cases and 26 negotiated purchases of wholly or partly US-owned properties were pending.[7] All but ten of these actions have been initiated since 1969. Of the total, about 40% are in extractive or extractive-related industries and 35% in banking and insurance. They are divided geographically as follows: 26 each in Latin America and Africa, eight in the Middle East, and 11 in Asia. In addition, numerous serious disputes between US-owned firms and LDC governments, involving concessions and other contracts, tax claims, and labor difficulties, remained unresolved. Although in most of these cases some progress is being made toward settlements acceptable to the US owners, these and similar nationalist-inspired actions continue to pose potential threats to US investment in the LDCs.

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17. The widespread increase in restrictions and controls on foreign firms is perhaps even more indicative of the changing climate for foreign investment in the LDCs. Although some LDCs long have closely regulated foreign investors, the number of countries imposing regulations has grown markedly since the mid-1960s, especially in Latin America, and the restrictiveness of the controls has tended to intensify. As indicated by such cases as Mexico, Brazil, and Indonesia, restrictive policies in themselves do not necessarily discourage entry of new investor capital, provided market incentives are adequate and political stability reasonably assured. Restrictions, however, have a pronounced impact in countries with relatively weak investor appeal and in areas where rules are subject to frequent change.

18. In general, the investment policies now being adopted by many LDCs seek to maximize benefits from foreign capital, management skills, and technology while limiting foreign profits, control, and sectors of operation. In a number of cases, profits are restricted by discriminatory tax and labor legislation, and limits on profit remittances have become more common. Foreign firms are under increasing pressure to use local supplies, employ local construction firms, hire and train local citizens for responsible positions, and so forth. Such pressures exist mainly in areas like Africa but also in those more advanced LDCs where backward and forward linkages with the domestic economies already are significant. Many LDCs now insist that new foreign operations in particular sectors be joint ventures with the local government or local private investors. In some countries, even minority foreign ownership is not permitted in such fields as banking and insurance (which allegedly absorb local credit resources) and exploitation of natural resources regarded as national patrimony. In some of the more advanced Latin American LDCs, pressure is also growing for closer controls on manufacturing investors on the grounds that their access to advanced technology and abundant capital gives them an "unfair" competitive edge over domestic manufacturers.

19. The rules governing foreign investors adopted in June 1971 by the Andean Common Market -- Chile, Colombia, Peru, Bolivia, and Ecuador -- are perhaps typical of the recent intensification of restrictions in a number of countries. Under these rules, each country may decide to reserve certain economic sectors for local ownership exclusively. If new foreign investments in mining, petroleum, and gas are permitted, they will be limited to concessions with a 20-year maximum life. All other new foreign firms except those exporting 80% or more of their output must have at least 51% local ownership within 15 years. Existing foreign firms must convert to a minimum of 15% local ownership, or 51% if they wish to obtain the common market benefits. Annual profit remittances are limited to a maximum of 14% of invested capital, and, with few exceptions, foreign firms are precluded from obtaining local credit or purchasing shares

of existing local firms. Foreign firms are not permitted to hold more than a 20% equity in public utilities, banking, insurance, inland transport, and communications media. Because the rules provide the member governments several escape clauses, their restrictiveness in application probably will vary considerably among the five countries.

Economic Impact of US Direct Investment in the Less Developed Countries

20. US direct investment in the LDCs as a group far exceeds that of the other developed countries and accounts for about half the total, compared with the one-fifth accounted for by the United Kingdom, its closest competitor.(8) US direct investment, however, predominates only in Latin America and the Middle East, being overshadowed by British investments in Asia and by both British and French in Africa. At the end of 1967, US direct investment accounted for two-thirds of total investment by developed countries in Latin America and 50%-60% in the Middle East but in Asia and Africa made up only one-third and one-fifth of the totals, respectively.

21. It is generally conceded that, by providing capital, management skills, and technology, US direct investment has contributed to economic growth and development in the LDCs. Without it, mineral resources in many less developed areas would have been difficult or impossible to tap. And, in Latin America particularly, it has helped to spark manufacturing expansion and to develop relatively advanced communications and electrical services as well as a sophisticated trade and financial network. Nevertheless, because relevant statistical data simply are not available, quantification of the contribution of US direct investment to the LDC economies is virtually impossible.

22. Statistics available on US investment in Latin America in 1966 do permit some useful, although tentative, measures of its economic impact in that area.(9) At that time, US wholly- or majority-owned enterprises accounted for an estimated 15% of aggregate Latin American gross domestic product and about the same share of total government tax revenues. Their foreign sales made up an estimated one-third of the region's total export

8. Largely because of basic definitional differences, intercountry comparisons of direct foreign investment are among the least satisfactory statistics and at best serve only as indicative approximations.

9. These statistics, which were compiled by the US Department of Commerce and released to the Council for Latin America, Inc., were obtained from the Council's report, **The Effects of United States and Other Foreign Investment in Latin America**, January 1971. Part of the statistics recently have been published in **US Direct Investments Abroad 1966, Part I: Balance of Payments**, by Frederick Cutler, US Department of Commerce.

earnings and some 6‹ ‰ 80% of the region's mineral export earnings. US-owned enterprises contributed roughly 10% of Latin America's manufacturing output in 1966 but 40% of manufactured goods exports, despite the fact that these enterprises produced mainly for domestic markets. Exports by US-owned manufacturing subsidiaries -- about half of which was shipped to the United States and consisted mainly of food products, textiles, and chemicals -- accounted for only 10% of their total sales in 1966.

23. The percentage contribution of US-owned enterprises to Latin America's manufacturing output and to its export earnings from manufactured goods almost certainly has increased since 1966. US direct manufacturing investments in Mexico, Brazil, and Argentina -- the major regional manufactured goods exporters -- have grown substantially, and the three countries' foreign sales of manufactured goods have increased considerably under government export drives. Among these, the major impetus to manufactured goods export expansion has come from the Mexican border industry program initiated in 1965. Under the program, some 250 US-owned electronics, textile, and other enterprises have been established in enclaves along the US-Mexican border to import raw materials and component parts from the United States (under bond and duty-free) for inclusion in finished products which in turn are sold mainly in the US market. Exports to the United States by these enterprises are expected to amount to some $350 million in 1971.

24. The data on Latin America also indicate that, contrary to frequent claims by the LDCs, US direct investment does contribute significantly to their net foreign exchange receipts. It is estimated that US wholly- and majority-owned firms made a minimum net contribution to Latin America's foreign exchange receipts of $1.7 billion in 1966. This figure consists of estimated export earnings of $4.5 billion less estimated total materials imports by all US subsidiaries of $1.3 billion and profit remittances of $1.5 billion. If import savings accruing from domestic sales by these US firms of manufactured goods (estimated at $3.9 billion) and processed minerals and other goods (estimated at $2.2 billion) also are included, the total net contribution by US firms to regional foreign exchange availabilities amounts to $7.8 billion.[10] It is probable, however, that a significant portion of this import substitution, at least in the manufacturing sector, would have been achieved by domestic entrepreneurs in the absence of US direct investment.

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10. The sales figures have been adjusted to exclude goods and services that do not enter into foreign trade. They also include a downward adjustment to reflect the fact that the prices of many goods produced in Latin America are much higher than the prices of similar imported goods, even after allowing for import duties.

25. In the Middle East and Africa, US direct investment is limited primarily to the mineral extraction and processing industries, but in Asia it has been instrumental in developing manufacturing, trade, and other activities. US direct manufacturing investments have been particularly important in the Philippines, India, and in the smaller economies of South Korea, Taiwan, Malaysia, Singapore, and Hong Kong, where they have obtained the highest average earnings rates for manufacturing among the LDCs. In the Philippines as well as India and some other large Asian countries, US direct manufacturing investments have been oriented mainly to domestic markets, but in the smaller economies they have been undertaken primarily to take advantage of low labor costs in producing for the US market. Nevertheless, in most of the smaller economics except the Philippines, South Korea, and Taiwan, US direct manufacturing investments are equaled if not substantially surpassed by those of Japan and the United Kingdom.

US Government and Company Policies Toward Investment in the Less Developed Countries

26. Encouragement of private capital participation in the task of foreign economic development is a longstanding US Government policy. Private investment capital never has been considered a substitute for official bilateral and multilateral financial assistance, which evidently is almost the sole source of foreign funds for infrastructural and other basic developmental projects. Nevertheless, it has become increasingly clear over the past decade that the widening gap between external financing requirements for LDCs and probable foreign aid appropriations for developed countries will be filled largely by private investment or not at all. US officials also have considered private investment to be the most efficient purveyor of advanced technology, managerial know-how, skilled labor training, and other essentials in the development process. LDCs have been given favored treatment in US foreign investment policy -- in particular they were exempted from most of the mandatory restrictions on investment outflows imposed by the United States in 1968.

27. The political risk investment insurance program -- formerly administered by the Agency for International Development (AID) but since January 1971 the province of the Overseas Private Investment Corporation (OPIC) -- is the US Government's most important current means of implementing its policy of encouraging direct investment in less developed areas. The investment insurance program minimizes risks of currency inconvertibility, expropriation, and damage from war, insurrection, or revolution that might otherwise discourage private investor entry into less politically stable LDCs. As stated in OPIC's legislative charter, the program pursues two broad objectives: (a) to assist those financially sound

investments that are welcome in the host countries and that evidently contribute to their socio-economic development and (b) to follow risk-management principles that will permit the Corporation to be financially self-sustaining.

28. In practice, it is sometimes difficult to fulfill simultaneously both objectives of the investment insurance program. Decisions affecting insurance coverage of large-scale US investment in LDC extractive industries provide the most obvious example of the difficulties involved. The large amounts of capital, long lead times, and high technology required for these projects effectively prohibit the LDCs from making such investments on their own, and in many countries -- Bolivia and Peru now and Chile at an earlier time -- mineral resource exploitation provides the only hope for significant economic advancement These same project characteristics (large-scale capital requirements and delayed pay-off), however, substantially increase the risks involved, particularly in LDCs where the investment climate is subject to sudden shifts and foreign involvement in natural resource exploitation is the **bete noir** of radical nationalists.

29. Despite these difficulties, the US Government has not been faced with large insurance claims before the presently looming Chilean imbroglio. The program currently is insuring some $500 million of new US investment annually, or about two-thirds of the total US investment flow to the LDCs, excluding that into petroleum industries. (OPIC policy precludes insurance on oil exploration, concession agreements, and investments in sub-surface property rights.) Political risk insurance of all types now outstanding for LDC areas totals $8.3 billion, somewhat more than one-half of which covers Latin American investments. As of mid-1971, gross claims paid were less than $5 million, whereas gross fees collected exceeded $125 million.

30. OPIC reserves, however, fall far short of total payments that may have to be made on insured US properties taken over by the Chilean government. Because OPIC insurance contracts are backed by the full faith and credit of the US Government, supplementary appropriations will be required from Congress in such an event.

31. Although US companies investing in the LDCs increasingly are taking advantage of the protection offered by government insurance, many of them -- especially in extractive industries -- feel that the program does not cover the risks most likely to be encountered in the politically more sophisticated but still unstable areas. They point in particular to discriminatory changes in tax, foreign exchange, and labor rules and to forced sell-outs of part of their equity holdings to protect their remaining "hostage" interests. In fact, a government insurance program can assume only a part of the responsibilities deriving from foreign investment decisions.

The major burden – as well as the primary benefit – of investment decision-making continues to rest with the private company. While most can be expected to avoid undue risks, growing dependence on LDC raw materials and the continued lure of quick, large investment returns in some fields are sufficient to induce investors into high-risk undertakings, thus increasing their exposure as well as that of the US Government.

32. Despite a new sensitivity to the problems and personalities of their host countries, US foreign investors often are accused of being less flexible than their West European and Japanese counterparts in adapting to the new game rules emerging in many LDCs. US companies do tend to assign more importance to retaining managerial control of an enterprise as a means of protecting their investment. In recent years, however, a growing number of US firms have entered into joint ventures with local governments and even so-called fade-out ventures now are receiving more serious consideration. Many companies nevertheless continue to view fade-out as unrealistic, citing that "foreign investors do not invest to go out of business," and some consider even joint ventures wherein they retain a majority interest as a giveaway of a share of the pot before the game has started. Although a more innovative approach by US investors to various equity schemes would substantially reduce their vulnerability to takeover and other punitive action in some LDCs, it is equally true that it would not make them immune to runaway erosion of the Chilean type.

US Gains and Losses from Direct Investment in the Less Developed Countries

33. A bright spot in the US balance of payments in recent years is income from direct investment in the less developed countries, which provided about \$3.1 billion in foreign exchange in 1970 (see Table 2) -- slightly more than the \$2.9 billion from similar investments in developed countries. Moreover, investment income from the LDCs in the 1960s has been much greater than new capital outflows to them, and the gap has been growing. The surplus for LDCs of \$2.2 billion in 1970 (compared with a deficit of \$0.5 billion for developed countries) was substantially greater than the \$1.3 billion and \$1.4 billion surpluses obtained in 1960 and 1965, respectively (see Table 3).

34. The bulk of the US surplus of direct investment income over new capital outflows to the LDCs comes from oil investments. In 1970 the petroleum sector provided about 80% of this surplus, compared with contributions of 10% by manufacturing, 8% by mining and smelting, and the remainder by all other sectors. Reflecting the concentration of oil investments in the Middle East, that area accounted for 62% of the total surplus in 1970, followed by Latin America, 24%; Africa, 13%; and Asia, 1%.

Table 2

Comparison of US Investment Income
with Net Capital Outflows, by Area a/

Billion US $

	1960	1965	1970
All countries			
Investment income	2.4	4.0	6.0
Net capital outflow	1.7	3.4	4.4
Surplus	0.7	0.6	1.6
Less developed countries			
Investment income	1.5	2.2	3.1
Net capital outflow	0.2	0.8	1.0
Surplus	1.3	1.4	2.2
Latin America			
Investment income	0.7	1.0	1.1
Net capital outflow	0.1	0.3	0.6
Surplus	0.6	0.7	0.5
Africa			
Investment income	0.0	0.2	0.6
Net capital outflow	0.1	0.1	0.3
Surplus	-0.1	0.1	0.3
Middle East			
Investment income	0.7	0.8	1.2
Net capital outflow	-0.1	0.2	-0.1
Surplus	0.8	0.6	1.3
Asia and Pacific			
Investment income	0.1	0.2	0.2
Net capital outflow	0.0	0.2	0.2
Surplus	0.1	0.0	0.0

a. Because of rounding, components may not add to the totals shown.

Table 3

Less Developed Countries: Comparisons of US Investment Income and Net Capital Outflows by Economic Sector a/

Billion US $

	1960	1965	1970
All sectors			
Investment income	1.5	2.2	3.1
Net capital outflow	0.2	0.8	1.0
Surplus	1.3	1.4	2.2
Mining and smelting			
Investment income	0.3	0.3	0.3
Net capital outflow	0.0	0.0	0.1
Surplus	0.3	0.3	0.2
Petroleum			
Investment income	1.0	1.6	2.2
Net capital outflow	0.0	0.4	0.5
Surplus	1.0	1.2	1.7
Manufacturing			
Investment income	0.1	0.1	0.3
Net capital outflow	0.1	0.3	0.1
Surplus	0.0	-0.2	0.2
Other			
Investment income	0.1	0.2	0.3
Net capital outflow	0.1	0.1	0.2
Surplus	0.0	0.1	0.1

a. Because of rounding, components may not add to the totals shown.

35. Statistics on net capital flows alone, however, do not measure the full impact on the US balance of payments since direct investment also heavily affects the US trade balance. Initially it contributes to US capital goods exports; but, later, US firms' production in the LDCs may adversely affect the US trade balance if production by US subsidiaries abroad replaces US exports or otherwise competes with US domestic production. Such investments are a main instrument for disseminating US technology and management skills, which have raised the capabilities of locally-owned firms in some LDCs to export relatively sophisticated manufactures to the United States. On the other hand, US investment raises real incomes in LDCs and consequently increases their demand for imports, including those from the United States. In general, US investments in extractive and service industries do not adversely affect the US trade balance. Investments in extractive industries lead to exports to the United States of goods that would have to be imported in any event, possibly at higher cost. US investments in service industries such as trade, public utilities, banking, and insurance by their very nature do not substitute for imports or generate exports. Thus, except in manufacturing, US gains from direct investment appear to generally exceed the surplus of investment income over the initial investment by approximately the amount of US capital goods exports generated.

36. Because of the complexity of the trade effects, an accurate netting out of US balance-of-payments gains from direct manufacturing investments in the LDCs is not possible. Only a few tentative judgments can be made. US direct manufacturing investments in Latin America, Africa, and the larger Asian countries allow US firms to gain entry behind protective trade barriers to produce for local markets. So far, only a small share of their output has been exported, mainly because they operate at relatively high costs. Although US manufacturing investment in Latin America has to some extent replaced imports from the United States, as in the case of automotive vehicles, it also substitutes for domestic investment and, to a small extent, for investments by other developed countries. In Africa and Asia, where direct investments of other developed countries predominate, US investments probably replace investments by other developed countries, and US firms' output displaces imports mainly from them. Thus the negative effects on the US trade balance of US direct investments in these areas probably are not great.

37. In some cases, however, US direct manufacturing investments have been effected wholly or partly to take advantage of low labor costs in the LDCs in producing for the US market. These cases include textile and electronics assembly industries in Hong Kong, Taiwan, South Korea, and along the US-Mexican border, as well as some textile and machinery investments in other Latin American countries, particularly Argentina and

Brazil. Even here, the adverse effects of these investments on the US trade balance probably do not significantly offset US investment income gains from them. The investments in East Asia and along the US-Mexican border were carried out to meet Japanese competition in the US market, and while imports from these countries have boomed, they probably displace further increases in Japanese exports to the United States. Moreover, the export-generated prosperity occurring in the small East Asian countries has, in turn, triggered a rapid rise in their imports from the United States.

38. Rising economic nationalism has had and is likely to continue to have a serious impact on US gains from direct investment in the LDCs. For example, much of the $71 million decline in total US direct investment earnings (i.e., before reinvestment) from LDCs in 1970 compared with 1969 is attributable to losses from nationalistic government action. Earnings drops of $158 million in Latin America and $54 million in Libya (where temporary government restrictions cut oil output) were not fully offset by gains elsewhere. While part of the Latin American decline results from other causes, nationalizations and measures to increase local shares of the profits of US firms in Chile, Peru, and Venezuela are major factors. On the other hand, not all nationalistic LDC actions have led to reductions in US earnings. For example, nationalization of copper properties in Zambia in January 1970 did not significantly reduce US earnings there because equity participation was exchanged for highly profitable service contracts.

The Special Case of Petroleum

39. Direct investments in petroleum dominate both US holdings in the LDCs and earnings from them. In 1970 the book value of LDC petroleum investments -- predominantly in producing facilities -- amounted to $8.4 billion, about 39% of total LDC investments, and oil earnings of some $2.3 billion accounted for 62% of total LDC earnings. The even larger US investment in refineries, pipelines, tankers, and marketing facilities in developed countries -- some $12 billion -- is totally dependent on oil supplies derived from investments in the LDCs. About 47% of LDC oil investments are in Latin America, 23% in Africa, 17% in the Middle East, and 13% in Asia. Partly reflecting company pricing policies that provide for higher profits on production than on refining and distribution, oil investment returns in LDCs are far higher than those from other direct investments, averaging 29% in 1970 compared with 11% for all non-petroleum investments.

40. US petroleum investments have had an enormous impact on the economies of the supplier countries. Government oil revenues sparked Venezuela's rise to second place in per capita gross national product among the Latin American countries in the early postwar years. They also have

provided almost the sole impetus to economic growth in a number of Middle Eastern countries, such as Iran, Kuwait, and Saudi Arabia. Oil revenues now provide 70%-99% of the foreign exchange earnings of all of these countries. Most have become heavily dependent on continuing rises in oil revenues to finance elaborate government economic development programs.

41. Although US oil properties were taken over as early as the 1930s in Mexico, they did not become a focal point for nationalist pressures until the 1960s, when restrictive and confiscatory policies spread to Brazil, Argentina, Venezuela, and other Latin American countries. In the late 1960s, nationalistic pressures also arose in the newer, more important oil producing countries in North Africa, the Middle East, and Asia. OPEC has become a highly effective instrument for imposing uniform demands on the foreign oil companies. Since many of these countries are unable to sustain oil output without foreign participation, their demands generally have sought greater profit shares and increased control over production rather than nationalization. The OPEC countries, however, also are now demanding equity participation in producing facilities, and a few countries have nationalized some relatively minor ancillary facilities such as domestic distribution systems. Thus far, US investment earnings have not suffered significantly from LDC successes in gaining larger profit shares, mainly because the companies have boosted oil prices to consumers.

42. Because 90% of proved Free World oil reserves are located in the LDCs (80% in the Middle East and Africa), US companies have had little choice but to continue their investments in these areas despite rising nationalist pressures, but recently they have favored investments in the more moderate countries such as Iran, Kuwait, Saudi Arabia, and Indonesia while avoiding Algeria, Libya, and Iraq. Reflecting the importance of oil investment income and growing US dependence on LDC oil supplies, the US Government has placed high priority on encouraging oil investments in the LDCs and grants the same depletion allowances to overseas investment as it does to domestic producers. In 1970, imports supplied almost one-fourth of US oil requirements, and some estimates indicate that by 1980 the import share may rise to almost 50%. Western Europe, where oil demand is expected to double in the 1970s, and Japan, where it may treble, are almost totally dependent on imports from the LDCs for their requirements. Although the largest capital outlays in the 1970s will go into developing "high-cost" oil in Alaska, Canada, and the North Sea, an estimated $30 billion will have to be spent in the LDCs to meet expected world demand. In view of the massive capital requirements involved, the governments of both oil producing and oil consuming countries may be obliged to assume part of the financing load, a responsibility they have thus far avoided.

Outlook

43. Economic nationalism probably will continue to adversely affect US gains over the next several years. Expropriations will continue, especially in the extractive and service industries; and the LDCs will continue to take measures to secure greater profit and ownership shares. However, because of the continuing need of the LDCs for imported technology, management skills, and capital, this may not have a serious long-term impact on aggregate investment earnings. The extent of possible US losses will depend largely on the flexibility of both US investors and their host governments in accepting viable forms of ownership and control and on their willingness to enter into management and service contracts.

44. Despite this less hospitable climate, growing US dependence on foreign sources of raw material supplies and attractive profit opportunities still available in some areas probably will generate continued growth in US direct investment in the LDCs as a group. Because of rapidly expanding markets in the developing countries, manufacturing activities may continue to attract an increasing share of US direct investment in the LDCs, but equally profitable opportunities in the developed countries will make such investment particularly sensitive to hostile policies. US firms involved in mineral exploitation will continue to shift some of their investments to lower-risk countries in the developed areas but, given the distribution of known world resources, there are limits to their ability to do so. Among the LDCs, the more advanced countries promising stability in investor rules (even if they are restrictive, as in Mexico) and some isolated countries not yet greatly affected by economic nationalism can be expected to attract most of the new capital. Although the willingness of US companies to participate in joint ventures with local capital probably will increase, it is even more likely that they will seek to reduce the risks involved in large-scale mining projects by forming consortiums with West European and Japanese investors, thereby internationalizing exposure to punitive action by host governments.

45. In the case of petroleum, demands for greater profit shares in nearly all LDC producing countries and gradual nationalization of US-owned oil properties in many promise to cut sharply into US investment earnings from crude oil over the next decade. Some LDCs, however, may not nationalize at all, and most probably will hold off until they have the necessary trained personnel and organizational experience, possibly several decades in the future in some cases. Moreover, most will have continuing need for cooperative relations with the US oil companies to help regulate oil production and to maintain ready access to developed country markets. Nevertheless, continuation of current trends will test the resourcefulness of the US oil companies and the Government to maintain market influence

and secure adequate oil supplies over the coming period. They will also add further stimulus to the present frantic search for new reserves in such high-cost but politically secure areas as Alaska, Canada, and the North Sea.